



Minutes of the Advisory Panel to DEFAC
Haslett Armory Dover, DE – October 20, 2017

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| Attendance: | Chairperson, Mr. Michael Houghton | | | P |
| K. Lewis | P | H. McDowell | | P |
| E. Ratledge | P | Q. Johnson | | P |
| K. Simpler | P | M. Ramone | | P |
| J. Bullock | P | A. DelCollo | | P |
| R. Geisenberger | P | R. Johnson | | P |
| M. Jackson | P | S. Malfitano | | A |
| M. Morton | P | D. Smits | | P |

Support and Staff Present:

A. Loiaconi, A. Aka, R. Goldsmith, J. Johnstone, N. Roby, D. Roose, S. Bailey, A. Jenkins, B. Scoglietti, S. Scola, D. Burris, B. Fahey, S. Steward, M. Marshall, A. Dillione

Members of the Public:

P. Morrill, B. Doolittle, E. Goldner, N. Cook

1. Call to Order

Chairman Houghton called the meeting to order.

2. Topical Recap and Requests

Chairman Houghton discussed the minutes and suggested they remain draft minutes until members have had more time with the document. Chairman Houghton recapped the prior meeting discussion of historical budget practices and issues and Pew's overview of other state practices regarding rainy day funds.

Mr. Jamie Johnstone, Economic/Fiscal Analyst with the Department of Finance, addressed a request to assess whether having bi-annual budget cycles would have solved Delaware's volatility problems. Available research showed that all but two states effectively use annual budgets. In bi-annual budget states volatility is increased due to greater forecast volatility.

Mr. David Roose, Director of Research and Analysis, discussed an analysis of NASBO data on 5-year revenue growth trends in all fifty states and D.C. compiled by the Department of Finance. The data showed that Delaware grew similarly to surrounding states and slightly slower than the national average if outlier (extraction tax) states are removed from the sample.

Mr. Simpler asked this sort of analysis could be made over a longer period.

Representative Ramone asked if a similar analysis was done around spending growth over the period. Mr. Johnstone responded that the balanced budget requirement means that expenditure growth is roughly tied directly to revenue growth.

Representative Ramone asked if this includes revenues from legal settlements. Mr. Johnstone stated that this covers anything that was part of the General Fund. Director Jackson noted that some legal settlements are required to be spent in specific ways by the settlement agreements and some portions are directed to Special Funds.

Secretary Geisenberger noted that doing a 50 state comparison at a detail of the level to include settlement payments would be difficult.

3. The Charge of the Advisory Panel

Secretary Geisenberger discussed House Joint Resolution No. 8's charges. Secretary Geisenberger noted that other taskforces have made previous recommendations surrounding Delaware's broad revenue portfolio issues as well as concerns with specific revenue categories. While the Panel is within its mandate to consider expenditures as a whole, Secretary Geisenberger mentioned that the challenges presented by specific expenditure categories are being considered by a variety of other taskforces. Secretary Geisenberger stated that beyond the specific re-evaluation of the 2015 DEFAC Advisory Council on Revenues report, the mandate asks the Panel to look at the existing processes and procedures around the Budget Reserve Account and the concept of a budget stabilization fund.

Treasurer Simpler noted that it may be helpful to define a common lexicon to keep discussion on point. In particular, there is a distinction between discussing the level versus the trend in both revenues and expenditures. Treasurer Simpler stated that the mandate asks the Panel to focus on the trends over levels, whether the current budget process allows the State to remain on a sustainable path according to economic indicators, and whether predictable, cyclical noise is being properly handled given present fiscal controls.

Mr. Ratledge noted that revenue sufficiency is also important to consider given predictable growth in current commitments such as pension liability.

Chairman Houghton stated that some of this is likely baked in with future projections and that the Panel's mandate is instead to focus on determining some construct that would smooth out the noise in the entire budget, rather than getting into the weeds of particular expenditure and revenue categories. Chairman Houghton reiterated that a variety of groups are studying specific issues.

Senator McDowell stated that budget stabilization is currently imposed annually depending on the current budget context. He noted that unclaimed property is a revenue category where revenue has been actively welcomed into the budget. Cutting done in last year's budget process may have shocked

some individuals, but also allowed for the elimination of less effective programs. Mr. McDowell discussed a variety of economic trends related to capital markets and wage growth in Delaware.

Representative Johnson noted that one of his visions for the Panel is to provide financial expertise to legislative members who are not as practiced in business and/or the budget process. The prior Advisory Council on Revenues offered a list of less volatile revenue options, but that the most recent budget solution neglected those solutions in favor of more narrow and volatile sources of revenue. Mr. Johnson noted that all these committees have been created to provide more objective recommendations for budgetary questions and to provide a means for holding Delaware politicians accountable for their choices.

4. Pew Charitable Trusts: State Case Studies

Stephen Bailey, Senior Associate from The Pew Charitable Trusts, gave a presentation covering the mechanics and history of rainy day funds in Idaho, Massachusetts, Virginia, and Tennessee. Mr. Bailey stated that the four examples cover a variety of structures in terms of deposit rules, withdrawal rules, and caps as well as demonstrate the pitfalls to be avoided in crafting and using a stabilization fund. These four states were chosen because of their clear practical rules, the quality of their accounting data for tracking purposes, and the inclusion of states that have experienced some of the downsides of stabilization funds.

Chairman Houghton commented that Virginia's solid history of rule following is surprising given a withdrawal rule which allows fund use as a result of revenue forecast error. Chairman Houghton noted such a structure for withdrawal rules appears to leave room for discussion about using the fund.

Senator DelCollo asked about the contractual or budgetary mechanisms that allow Massachusetts to set aside settlement dollars in their rainy day funds.

Chairman Houghton stated this presentation would suggest you can formulate a variety of potential withdrawal rules, but that it is important the budget process is disciplined and involves responsible rule following.

Chairman Houghton noted the presentation makes clear that bond rating downgrades as seen in Massachusetts represent one real check on political uses of stabilization funds.

Secretary Geisenberger noted that rating agencies have looked favorably upon Delaware's refusal to carry a negative cash balance into the next year. This is not strictly required by statute, but Delaware's legislature and executive administrations have taken the disciplined measures, such as hiring freezes, to ensure this does not occur. Secretary Geisenberger noted that having a smoothing fund may have reduced the scale of action necessary in the past.

Treasurer Simpler stated that there is a fundamental difference between receipts, forecasts, and the economic cycle. Treasurer Simpler suggested one conclusion to be drawn from Pew's presentation is

that rules that rely on objective, independent measures help ensure budgetary actions remains in line with the underlying economy.

Chairman Houghton asked Mr. Bailey to assess which states have had the best experience, and how much of that success was relate to culture as opposed to rules.

Mr. Bailey stated that whatever implementation ensures the rules are followed as closely as possible is the best implementation according to credit rating agencies. Pew generally advocates for rules that save based on a trigger as opposed to from a surplus in order to prioritize savings over other options that might become available. Mr. Bailey stated Pew's position is agnostic on rule structure as long as those rules clearly define extraordinary revenue growth.

Mr. Bailey, in response to a question from Senator DelCollo, stated that the use of fiscal controls based on a specific revenue stream versus controls measured through overall revenue trends depends more on buy in from people engaged in the process than one format being better than the other.

Representative Johnson noted that the Joint Finance Committee (JFC) has built a culture that does well in following the rules at present regardless of the budget situation at hand. The role of this and other committees should be to improve the budget situation the JFC faces each year.

Mr. Bailey, in response to a question from Chairman Houghton, stated that broad and narrow deposit rules are both sufficient for building a reserve so long as the structure of the rule results in sufficient funds being stored. To this end, the modelling of potential rules is essential to making any implemented rules work.

Representative Ramone suggested a blended funding rule of both broad and narrow fiscal controls.

Secretary Geisenberger suggested that staff build a presentation on the various features, pros, and, cons of potential budget smoothing constructions. This panel should agree upon the target principles required for a good budget smoothing procedure and then develop options that fit those principles.

Senator McDowell noted that forecast rules would have to specify which forecast was used for comparison. Senator McDowell requested that the most accurate revenue projections possible be provided as soon as they can be produced.

Secretary Bullock asked if some examples of states with recent revenue trends similar to Delaware's could be presented. He noted that the Virginia example is nearly identical and thus a relevant comparison.

Secretary Geisenberger asked that the council consider some states that are comparable in actual revenue trends and in personal income growth in recent history.

Chairman Houghton stated the sense that the Panel members are in agreement that a revenue stabilization fund would be worth establishing.

In response to Secretary Bullock's concerns about how slow Delaware revenues have grown recently, Representative Johnson noted, if the work of the prior Advisory Council on Revenue were enacted, the stabilization discussion would likely be less academic. This Panel has then been asked to work backwards in establishing a stabilization fund before revenue sufficiency has been addressed.

Representative Ramone noted that this discussion should include reconfiguration of existing budget controls and the existing revenue portfolio, as well as the addition of new controls such as a stabilization fund.

Chairman Houghton suggested that the next two meetings should be sufficient to consider the broad array of options and craft a recommendation that considers existing controls and new options. Additional consideration should also be given to the fact that extraordinary events may force Delaware's hand in adjusting these measures.

Representative Johnson asked Senator McDowell to comment on the revenue context and budgetary climate that exist when the current Rainy Day Fund was established.

Senator McDowell stated the Budget Reserve Account was established because Delaware was in the midst of severe financial issues, but that it was not conceived as being the inaccessible fund it has become.

5. Measuring Delaware's Means and Needs

Mr. Johnstone and Susan Steward, Policy Advisor with the Office of the State Treasurer, gave a presentation covering independent, economic measures of Delaware's economy. Mr. Johnstone briefly discussed growth in regional economic measures that are correlated with Delaware's tax bases. Tax bases are often thought of as a measure of an economy's "means". Over time, each of these bases have become increasingly volatile, but with strongly correlated long-term trends. This correlation means a balanced tax structure could smooth revenue growth over time and lead to roughly the same amount of revenue. Mr. Johnstone noted that how a state's tax portfolio is structured determines how it will respond to changes in the national business cycle.

Treasurer Simpler noted that the structure of Delaware's tax portfolio in the nineties' business cycle was well aligned to take advantage of national trends. However, since that time, the drivers of subsequent business cycles have varied significantly and the current state structure has not captured the growth as effectively.

Ms. Steward discussed a comparison between the ten-year rolling average of Delaware revenues and rolling averages of various measures of the state's economic and demographic growth (CPI-U, state and local price deflator, and population) which may be viewed by some as proxies for demand for State government services and baseline cost growth--the measure of underlying "needs." The rolling revenue growth rate shows a significant downward trend while measures of price changes, such as the national State and Local GDP Deflator and regional CPI-U, are more consistent. Ms. Steward stated that the

measures of growth of “needs” presented have historically been well below the 10-year trend revenue growth.

Treasurer Simpler stated that the rolling averages presented show Delaware specific “means” as sufficient to provide acceptable levels of service growth. Though growth in the proxies for “needs” was slightly slower than historical revenue growth, the proxies still grow at potentially satisfying rates.

Mr. Ratledge noted that the history presented corresponds with the peak earning years of Baby Boomers, and that projecting the same trend forward will likely be inaccurate. Mr. Ratledge stated that the aging of Delaware’s populace will result in a growing portion of personal income from transfer payments, like Social Security. Many transfer payments do not generate much, if any, Delaware tax revenue.

Mr. Simpler noted Delaware’s current budget infrastructure is built on the assumption of higher revenue growth, but these independent measures of means and needs suggest a lower growth rate for service provision should be sustainable.

Chairman Houghton agreed, but noted that the tough decisions involved with that adjustment will not be made in this Panel.

Senator McDowell suggested including a measure of the county governments’ means and needs and whether they have bandwidth to increase their burden.

Mr. Johnstone noted that, for the purpose of these independent measures, county-level means and needs would be no different than the measures presented.

Senator DelCollo stated this presentation makes clear the importance of imposing a rational fiscal control related to the State’s relative means and needs, in addition to the current discussion around a budget stabilization fund.

Representative Johnson noted that a smoothing fund could impose its own fiscal control given the annual balanced budget requirements.

6. Discussion

Chairman Houghton stated that staff is tasked with putting together additional analyses and recommendations and Pew will provide more information about more comparable states.

7. Public Comment

Mr. Doolittle, an advocate for children, stated he is a strong support of a counter-cyclical fund which would be stronger if its triggers were economically based. He reiterated his concern that using unencumbered funds as a source of revenue is very problematic and amplifies the available appropriation level variance. Mr. Doolittle stated that the Panel will be missing a significant opportunity if the mechanisms developed do not address this issue.

Ms. Goldner, from Hope Street DE Inc., stated her concerns about how the most recent economic crash and slow recovery have negatively impacted mental health and substance abuse rates in Delaware. She emphasized the importance of stimulating the Delaware economy and empowering people to make things in order to improve aggregate mental health. Ms. Goldner noted that doing this would have a variety of cost savings benefits for the State.

Secretary Geisenberger noted that a recent Moody's study stress-testing state-level budget reserves as a means toward weathering the next recession should be analyzed by Panel members before the next meeting.

8. Adjournment